Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:POSTF-113049-02
WRDavis

date: **April 8, 2002**

to: Team Manager, [redacted] audit (LMSB: [redacted])
Attn: Revenue Agent [redacted]

from: Area Counsel
(Natural Resources:Houston)

---

subject: **Request for LMSB Counsel Assistance:**
Was [redacted] Entitled to Reimbursement for its Costs in the Event of Steam Failure on the [redacted]?
Taxpayer: [redacted], Inc.
TIN:
Address: [redacted]

Reference is made to your memorandum dated February 26, 2002, in which you seek our opinion concerning interpretation of a contract. Specifically, you ask whether [redacted] would have been entitled to reimbursement for costs incurred under its agreement with the [redacted] to build a [redacted] power plant in the event of steam failure prior to the commercial operation date. This memorandum should not be cited as precedent.

Please note that, as nondocketed significant advice, this advice is subject to a 10-day post-review by Chief Counsel National Office. Once this review has been completed, I will contact you to advise of its acceptance upon review, or of any modifications to the proposed response.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure of this document becomes necessary, please contact this office for our views.

FACTS

On [redacted], [redacted] ("taxpayer"), entered into an agreement entitled "[redacted] - [redacted] between [redacted] and [redacted]" ("the Agreement"). [redacted] ("[redacted]") is a wholly-owned subsidiary of the [redacted]. In summary, the Agreement permits the taxpayer to build a [redacted] power plant in the [redacted] portion of the [redacted] area of the [redacted], [redacted], and to operate it for a period of [redacted] years. The facility is comprised of [redacted] generating units of approximately [redacted] gross output each. During that period, the Agreement obligates the [redacted] ("[redacted]") to purchase from the taxpayer the electricity generated at the plant. At the end of the [redacted]-year period, the Agreement calls for the taxpayer to transfer the power plant to [redacted]. The Agreement identified, in the recitals, that [redacted] had invited proposals from several contractors for the design, construction, operation, and maintenance of such a plant on a [redacted] basis, and that this was authorized under the [redacted], also known as the [redacted].

Contract Interpretation

Some of the more significant portions of the contract include section [redacted] - "[redacted]," which obligates [redacted] to supply and deliver all steam, in conformity to the Steam Specifications of the Agreement and at no cost to the taxpayer, as Operator. Next, Section [redacted] identifies the taxpayer as the owner of the Power Plant and all fixtures, fittings, machinery and equipment on the site that are used in connection with the Power Plant and which have been supplied by, or paid for by the taxpayer, from the Effectivity Date until the Termination Date, the Buyout Date, or the Transfer Date, whichever comes earlier. Significantly, the Effectivity Date is not the date that the Agreement is reached, but rather the date after which [redacted] satisfies the conditions set forth in section [redacted], and after which the taxpayer satisfies the conditions set forth in section [redacted]. Article [redacted], defining effectivity, provides that the stated conditions referenced above must be met or waived in writing within [redacted] days of the execution of the Agreement; however, if this does not occur, the Agreement requires the parties to meet and discuss in good faith means of achieving effectivity including the extension of the [redacted]-day period.

The Agreement defines the Cooperation Period as the [redacted]-year period of commercial operation, starting from the Commercial

Operation Date of the [redacted] generating unit and continuing until the [redacted] anniversary of that date. During such time, the taxpayer is required to deliver electric capacity and energy to [redacted] on behalf of [redacted]. Pursuant to Section [redacted], the guaranteed completion date of the [redacted] generating unit was [redacted], and the guaranteed completion date for the [redacted] and [redacted] generating units was [redacted]. Section [redacted] permits the extension of these dates by the duration of any event of force majeure or any breach by [redacted] of any of its obligations under the Agreement. Under section [redacted], the taxpayer was also entitled to payment for delivery of electricity to [redacted], on [redacted]'s behalf, after the Commercial Operation Date.

Section [redacted] makes the taxpayer responsible for procuring all requisite Government authorizations, licenses and permits for the construction and initial operation of the Power Plant other than the Environmental Compliance Certificate, Authority to Construct and Permit to Operate, which are the responsibility of [redacted]. This provision limits, however, the taxpayer's maximum outlay to $[redacted].

Section [redacted] sets out the effect of the inability to complete the performance tests required under section [redacted]. If such occurs because steam is not available when the generating unit is capable of being tested, the Commercial Operation Date for that unit shall be deemed to be the date after the performance test would have been completed in accordance with the schedules in section [redacted]. From the Commercial Operation Date, the taxpayer is entitled to receive Capacity Payments based on the contracted capacity of an affected generating unit. Once the steam is available, the testing is to be undertaken, and the payments will be based on the Nominated Capacity (output specified by the taxpayer), determined in connection with the performance tests.

a. Buyout

Article [redacted] includes details of the different circumstances under which [redacted] is required to buy out the taxpayer's interest in the power plant prior to the expiration of the [redacted]-year cooperation period. One is triggered by the parties' inability to agree ([redacted]) whether the modifications to the facility design that [redacted] requires of the taxpayer under section [redacted] will likely impair the taxpayer's ability to perform its contractual obligations; ([redacted]) to adjust the contract capacity price to account for the modifications; or ([redacted]) to adjust the contract dates to reflect any delays caused by the incorporation of such modifications. In the absence of agreement to any of these matters, upon written notice by either party, section [redacted] obligates [redacted] to purchase all of the taxpayer's right, title, and interest in the power plant.[1]

Additionally, under section [redacted], if any condition of force majeure delays a party's performance for greater than [redacted] days, either party may, upon written notice, terminate the Agreement, with Article [redacted] applying. Section [redacted] defines force majeure as

[redacted]

Based upon this broad definition, we believe that a steam failure due to a change in geothermal conditions and not within the reasonable control of a party will fall within the definition of a condition of force majeure.

b. Abandonment During Construction

In section [redacted], the Agreement sets forth the circumstances under which construction of any or all of the generating units or the power plant is deemed to be abandoned by the taxpayer. Relevant to this question, under section [redacted], where the taxpayer fails to resume work within [redacted] calendar days following the termination or cessation of a force majeure situation that caused no material damage to any generating unit, provided that a notice of such termination or cessation was given to the taxpayer by [redacted], the construction of the affected generating unit shall be deemed abandoned.

In the event of abandonment during construction, after a [redacted]-day period following [redacted]'s written notice to the taxpayer of its intention to terminate the Agreement, the taxpayer is required to transfer, upon payment by [redacted] of a purchase price calculated pursuant to section [redacted] for completed generating units, all right, title, and interest in the power plant to [redacted]. Agreement, section [redacted] (flush language).

---

[1] Section [redacted] gives [redacted] one last chance to withdraw its request of the taxpayer within [redacted] working days following the taxpayer's delivery of written notice of termination under this section.

c. **Abandonment During Cooperation (Operating) Period**

In section [redacted], the Agreement sets forth the circumstances under which the power plant is deemed to be abandoned by the taxpayer after all [redacted] generating units have come on line. Relevant to this question, under section [redacted], where the taxpayer fails to resume delivery of electricity to [redacted] within [redacted] calendar days following the termination or cessation of a force majeure situation that caused no material damage to any generating unit, provided that a notice of such termination or cessation was given to the taxpayer by [redacted], the power plant shall be deemed abandoned.

In the event of such an abandonment, after a [redacted]-day period following [redacted]'s written notice to the taxpayer of its intention to terminate the Agreement, the taxpayer is required to transfer, without any payment by [redacted], all right, title, and interest in the power plant to [redacted]. Agreement, Section [redacted] (flush language).

d. **Buyout Price**

In the event that, under either the buyout conditions of section [redacted] or the abandonment provisions of section [redacted], [redacted] must pay the taxpayer for the power plant, the buyout price is to be determined in accordance with section [redacted]. The amount due to be paid depends upon whether the amount is payable before the generating unit reached its commercial operation date or not.

For buyouts prior to commercial operation of the [redacted] generating unit[2], the purchase price is an amount equal to the aggregate of all the costs and expenses (including accrued interest and other direct costs incurred in financing the development of the Power Plant) incurred by the taxpayer in connection herewith as estimated by an independent accountant jointly appointed by the parties plus an amount equal to [redacted] percent of such aggregate. The additional [redacted] percent is not payable if it is a buyout under section [redacted], arising from a force majeure other than a political force majeure. Agreement, section [redacted].

---

[2] We believe that this is a typographical error, and should have referred to buyouts prior to operation of the [redacted] generating unit. Otherwise, both sections [redacted] and [redacted], infra., govern buyouts occurring after commercial operation of unit [redacted], but before commercial operation of all [redacted] units. In any event, the ambiguity does not affect our opinion.

For buyouts after the commencement of commercial operation of all [redacted] generating units, the purchase price equals the net present value of the remaining stream of payments for capital cost recovery fees, discounted from the transfer date to the date of completion of the buyout on the basis of the most recent Nominated Capacity or the Contracted Capacity, whichever is lower. The discount rate is also specified by reference to an index rate, but cannot exceed [redacted]%. Agreement, section [redacted].

For buyouts after the [redacted] generating unit is on line, but prior to the commercial operation date of the [redacted] generating unit, the purchase price for each of the completed units is to be determined using the same method applied to buyouts after all generating units have begun commercial operation, and the purchase price for each of the other units is to be determined through the aggregation of costs and expenses incurred by the taxpayer in connection with these unit's construction, with the [redacted] percent addition, if applicable. Any cost solely for construction of any generating units already in commercial operation is to be deducted from the amount calculated for under-construction units. Agreement, section [redacted].

e. Governing Law

Finally, Article [redacted] specifies [redacted] as the law under which the Agreement is governed and construed.

[redacted]

In [redacted], the [redacted] enacted [redacted], which has come to be known as the [redacted]. This law was enacted to draw foreign investments to undertake infrastructure projects, such as electric power generation and telecommunications in [redacted]. [redacted].

As in effect as of the date of the contract between the taxpayer and [redacted], the [redacted] defined a "build-operate-and-[redacted] scheme," in pertinent part, as follows:

[redacted]

[redacted]

[redacted].

Most significant, the [redacted] contains a provision that concerns those circumstances where the project cannot go forward to completion. That section, entitled "[redacted]," provides as follows:

[redacted]

[redacted].

The [redacted] has been modified subsequent to the Agreement date; however, the changes made thereunder are prospective in nature. [redacted].

DISCUSSION

We first note that the Agreement, by its terms, is to be construed in accordance with [redacted]. We further note [redacted].

Foreign law, as interpreted in the courts of the United States, is a fact upon which expert testimony is admissible. Chemical Bank New York Trust Co. v. Kennedy, 199 F. Supp. 256, 259 (D. D.C. 1961), reversed on other grounds 319 F.2d 720 (D.C. Cir. 1963), cert. denied 375 U.S. 965 (1964). See also Harris v. American International Fuel & Petroleum Co., 124 F. Supp. 878 (W.D. Pa. 1954); Dubitzky v. Commissioner, 60 T.C. 29, 35 (1973). What can be used to prove foreign law, however, is more flexible. In Federal courts, a court may consider any relevant material or source, whether or not admissible under the rules of evidence, in determining an issue under foreign law. Carpenter v. Commissioner, T.C. Memo. 1993-97 n.4; Fed. R. Civ. P. 44.1.

Nothing in the [redacted], memorandum provided by the taxpayer's counsel sets forth the basis for the taxpayer's version of foreign law. To the extent you see the issue of the correct interpretation of [redacted] as critical, you may wish to seek further explanation from the taxpayer of the basis of its opinion. With this in mind, we note that foreign law is generally subject to discovery. Owens-Illinois, Inc. v. Commissioner, 76 T.C. 493, 496 (1981) ("Discovery is an appropriate tool to enable a party to make a reasoned judgment as to the applicability of foreign law"). Please feel free to re-involve us if you would like our assistance in drafting questions to obtain information regarding the taxpayer's view of [redacted].

Likewise, however, our opinion concerning the interpretation of both the Agreement, and what we believe to be the applicable [redacted], is beyond the scope of our area of expertise. To assist in your evaluation of this issue, we have provided our interpretation of [redacted] for your consideration--not, however, as an authority in that country's law. Should you view this issue as crucial to your position concerning the value of the contract on transfer, or if the taxpayer presents an authoritative interpretation of [redacted] contrary to ours, we suggest that you consider seeking an expert in [redacted] and [redacted] to opine regarding the proper reading of these areas of law.

With the foregoing precautions, we believe that, under common law contract principles, the Agreement provides relief for the taxpayer, as Operator, in the event of a failure of [redacted] to provide steam in accordance with the terms of the Agreement.

Beyond that, we believe that, in instances where an operator such as the taxpayer undertakes a project pursuant to the [redacted] provides for compensation by the [redacted] government of the operator's actual expenses, plus a reasonable rate of return (up to the amount specified in the bidding documents), in the event of the cancellation, revocation, or termination of the contract with the operator by the government, or by mutual agreement of the parties. Our reasons follow.

Contract Rights

In its explanation of the "Reimbursement Issue," the taxpayer reads the definition of force majeure as "[redacted]." [redacted] (emphasis original). This belies the definition contained in the Agreement.

The Agreement's definition of "force majeure" is broad. It covers "[redacted]." (Emphasis added). Clearly, [redacted]'s requirement to provide steam to the taxpayer within parameters specified in [redacted] of the Agreement fulfills the "obligation" part of the definition. Likewise, an inadequate steam supply attributable to geological conditions, regardless of the reasons for the change from the steam supply disclosed by exploration, is a circumstance beyond the reasonable control of the taxpayer, and one which would materially affect the taxpayer's ability to provide electricity in conformance with the Agreement. In our view, this change in circumstances would fit squarely within the definition of force majeure contained within the Agreement.

Likewise, we note the inapplicability of the Abandonment clauses of the Agreement. In the context of these facts, they would only apply if a force majeure event ended, and performance under the Agreement again became possible. Your request posits a permanent steam failure. Thus, the Abandonment clauses do not apply.

Force Majeure

A review of [redacted] statutes and case law makes clear that unforeseeable changes, or those which, although foreseeable, are unavoidable, fit squarely within the definition of force majeure. A steam failure would, under [redacted], constitute just such a change. That law has contained the same statutory force majeure clause in its civil code since [redacted]. At that time, it enacted Article [redacted] of the Civil Code of [redacted], stating as follows:

[redacted]

The [redacted] has elaborated on the elements necessary for force majeure to exempt a person from liability:

[redacted]

If it were found that the force majeure provision was inapplicable to a steam failure, we believe that the [redacted] would have acted to make the taxpayer whole. It unambiguously provides for compensation for actual expenses, plus a reasonable rate of return, to a non-culpable contractor such as the taxpayer. Thus, it appears that the taxpayer was protected from much, if not all, of the risk from the revocation, cancellation, or termination of the Agreement where such occurred through no fault of its own, <u>outside</u> of any remedies under the Agreement.

Recalling that the [redacted] is a subsidiary of the [redacted], it is therefore an instrumentality of the [redacted]. We note the significance of the [redacted] contracts--like the Agreement--to [redacted] upgrading of its infrastructure. <u>See</u>, <u>e.g.</u>, [redacted]

[redacted]. In our view, [redacted] would not likely fail to compensate the taxpayer for costs it occurred where the supply steam was later found to be inadequate. We speculate that the potential political damage that such a breach would cause to its infrastructure development through such agreements would likely prompt the [redacted] to reimburse a private sector participant, like the taxpayer, for its outlays.

Please contact the undersigned at (303) 844-2214, ext. 259, should you have any questions regarding this memorandum.

BERNARD B. NELSON
Area Counsel
(Natural Resources:Houston)

By: William R. Davis, Jr.
WILLIAM R. DAVIS, JR.
Attorney (LMSB)